RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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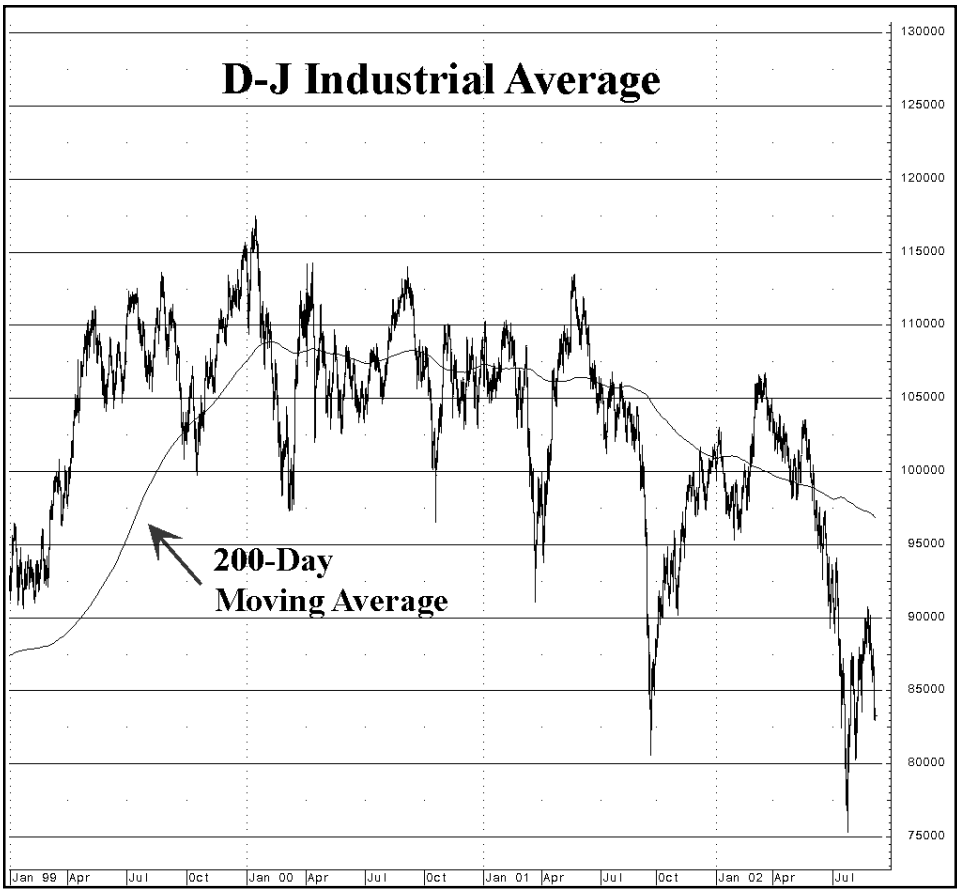
Aug. 23, DJIA 8872.96; PTI 5252; A-D Ratio -2.38
Aug. 30, DJIA 8663.50; PTI 5244; A-D Ratio -2.50
Sept. 6, DJIA 8427.20; PTI 5244; A-D Ratio -2.59
S&P Yield: 1.72% S&P p/e: 36.10
Gold 50-Day MA: 314

THE KEY CHART -- For subscribers who don't have computers or who don't read my daily remarks on our website, I want to delve into the mysteries of the 200-day moving average. This is probably the most basic and most-accepted and most-followed of all technical studies. I call it the "daddy" of all technical methods.

George Schaefer, the great Dow Theorist of the 1940s through 1970s, made constant use of the 200-day moving average (MA). Schaefer explained it this way – The 30 Dow Industrial stocks are the most watched and analyzed group of stocks in the world. The D-J Industrial Average is the blue chip Average, and it contains the type of investment-grade stocks the large, seasoned investors want to buy and hold.

Thus, the key barometer of the US stock market and the US economy is the Dow. There is no more powerful force in the market than a steady, relentless rise in the D-J Industrial Average. A steady and consistent rise in the Dow is always a characteristic of a primary bull market in stocks. By the same token, a persistent and extended decline in the Dow is always a characteristic of a bear market. No bear market in history has ever progressed for very long without leadership on the downside from the Dow.



To trace the long-term path of the Dow, Schaefer used the Dow's 200-day moving average. In fact, Schaefer termed the Dow's 200-day MA the "Investment Line." What he meant was that the Dow's 200-day MA shows us the path that the big, seasoned investment

money is taking. And where the big investment money goes, the rest of the market invariably follows.

If there is one KEY chart in the whole stock market picture at this time, it's the chart I include on the front page of this report. Here we see the Dow and its 200-day moving average. The 200-day MA hit its bull market high in February 2000 at a price of 10887. And as you can see, the 200-day MA has been declining irregularly ever since. The latest reading on the 200-day MA is 9663. This is the lowest reading of the Dow's 200-day MA since the bear market began.

If there was ever a single measure that followed the path of this bear market this is it – the relentless decline in the 200-day MA of the Dow. I expect the 200-day MA to continue to decline until the bear market hits its final bottom. Yes, there will be periods when the bear market corrects and at such times we may see the Dow temporarily break out above its 200-day MA. But as I said, these explosive surges above the 200-day MA will be short-lived, only to be followed by renewed weakness and another plunge below the 200-day MA.

Finally, at the bear market bottom, at a time when stocks have returned to great values, we will see the Dow advance and break out above its 200-day MA. That action will signal that a new bull market is underway. But right now, with the Dow well below its 200-day MA, we can say that large, seasoned investors are paying less for the Dow (based on the average price over the last 200 days) than at any time since the bear market began. Big money is leading the bear market down, and the proof lies in the path of the Dow's 200-day moving average. You can see it on the page 1 chart.

BIG PICTURE – Every bear market in history is about "something." All bear markets have one thing in common. That one thing is over-speculation during the preceding bull market.

In the third or final phase of a bull market volume becomes excessive, speculation becomes excessive, rumors become rampant, and well, just about everything goes to extremes, as we saw during 1996 to 2000.

Bear markets serve, among other things, to erase the excesses seen at the preceding bull market top. Bear markets serve to remind people that they've spent too much time at the punch bowl. Normally, the Fed is supposed to take the punch bowl away when the crowd gets too wild.

But unfortunately, Alan Greenspan neglected to do that following his famous late-1996 speech. In fact, Greenie actually bought the myth of the "New Economy" and its "miracle productivity," and he flooded the system with liquidity just to keep the New Economy going at full speed. What happened was the punch bowl finally cracked. There was just too much alcohol in the punch bowl and it cracked wide open.

So yes, there was a lot of speculation during 1996 to 2000. But there was also something very fundamental behind the bear market that took over from the bull market. That fundamental was worldwide over-production. Over the last decade many nations have learned how to produce and how to compete. Nations that had never before competed in the world export markets learned how to produce just about every type of goods from cars to computers to soy beans to refrigerators.

Walk into any large store such as Target or Wal-Mart or Costco and check out the merchandise. Chances are that whatever you pick up, whether it's a shirt or a tool or a table — it will say made in China or Malaysia or South Korea or Taiwan or Thailand. The US has exported a large portion of its manufacturing facilities to foreign lands. And with every factory that is closed-down here, and opened somewhere else – jobs are lost. Tens of thousands of jobs have been lost in the US as the great migration of manufacturing facilities continues.

But more recently, many foreign nations have moved into the loftier regions of high-tech manufacturing and even of service. Computers, computer programming, biotech, scientific research, all of this is now evident in other nations. It's a new world, and the US is no longer the undisputed leader in manufacturing and service.

But as I said, the basic problem has now become world over-production. Of course, the fundamental "treatment" for over-production is recession, cooling off, and some bankruptcies on the part of inefficient suppliers. But a recession also presents a political problem, and politicians have one overriding priority. That priority is to remain in office. How does one stay in office in the face of recession? You do it by fighting the natural forces of recession — you do it by dropping rates and jazzing up the money supply.

As I see it, that's where we are now — namely, in the fight against recession. I've predicted that this battle was coming for the last few years. And I've named it the battle of — **INFLATE OR DIE.**

As this is written the Fed is doing all it can to re-inflate. The last statistics from the St. Louis Fed show that MZM (money of zero maturity or literally cash) is growing at an annualized rate of just over 12%. Rates remain at a 41-year low.

What else can the Fed do? Maybe "stabilize" the market when it drops to critical levels. Would the Fed do that? Yeah, I think it would — I think the Fed would do anything to keep this economy from going into the tank.

But a major bear market is in force, and that force has tremendous deflationary implications. The bond market sees it. The stock market sees it. Why don't the analysts and strategists see it? They don't see it because they either haven't learned to read the language of the stock market or they simply don't believe what the stock market is saying.

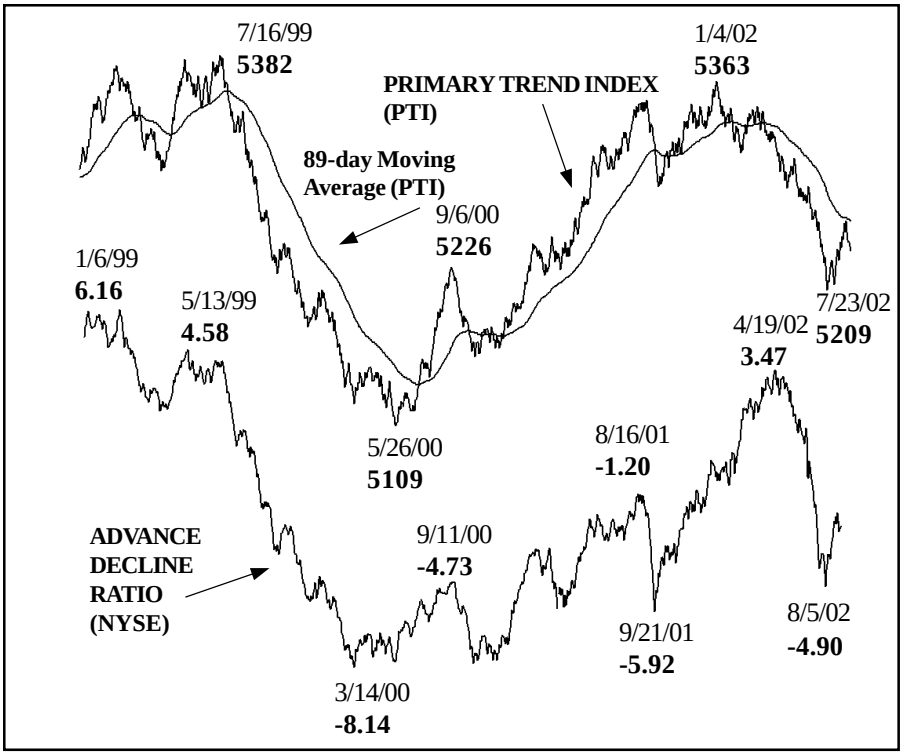
It makes no difference either way. We're on a long journey to what, if you want to be optimistic you can call – the decline to great values. Yes, the KEY gauge of when this bear market is entering its final low will be the return of great values in stock valuations. Two criteria will be used to classify stocks as great values. Blue chip stocks will be selling at ten times or less their earnings, and these same stocks will be providing dividend yields of 5%, 6% or more. These are the valuations found at every major bear market bottom of the last century. We will see them again before this bear market is over.

DIVIDENDS – The "cash-in-hand" method of investing has been the time-honored way – until recent years. During the '90s, dividends were no longer fashionable, and the emphasis was on growth. Why give investors dividends when the corporation, in its great wisdom, could plow all of its profits back into company growth.

That was a marvelous idea during the bull market when stocks had only one way to go – up. But when the bear market entered the picture, fading growth gave way to declining prices, and investors suddenly perceived that their stocks had lost 25%, 50% and 75%. Furthermore, their stocks had never paid a dividend. This was hardly the path to an investor's retirement.

In fact, what the investor realized was that he was holding "dead wood." He bought a stock for 60, it went to 80 (great), then during the bear market the stock dropped to 30, and the damn company had never paid out a cent in dividends. What was the investor holding? "Dead wood" with the HOPE that someday, some how, he'd break even with his ill-timed, dividend-less purchase.

The fact is that dividends provide a cash return and a safety net when share prices head down. And just as important, over time dividends offer proof that a company is producing actual profits, profits that can be shared with its owners. The dividend yield on the S&P fell from 5% in the late '80s to the minuscule 1.7% today.



According to a soon-to-be published study in the *Financial Analysts Journal*, there's a definite link between earnings growth and pay-out-ratios. The ratios represent the percentage of profits that a company pays out in the form of dividends.

"The historical evidence strongly suggests that expected future earnings growth is fastest when the current dividend payout ratios are high and slowest when the payout ratios are low," according to the study by Robert Arnott and Clifford Asness, partners in a hedge fund.

Their study looked at the earnings and dividends for the 500 S&P companies from 1950 to the year 2001. What they found was the companies with the highest dividend payout ratios generated inflation-adjusted profits of 3.2% a year versus only .07% for those with the lowest payout ratios. Said Arnott; "Earnings growth is wonderful when the dividend payout is high and appalling when it's low."

Dividends are also the way to total return, which combines earnings growth and dividend income. From 1871-2000, dividend yield has provided 50% of the total return in equities. With this bear market having further to go, possibly years to go — dividends could make up the great bulk of any total return.

One important objection I have to "no dividends" is that without dividends you cannot compound your assets. And you cannot diversify. A steady stream of dividends allows you to plow your money back into other dividend-paying stocks or even into bonds.

Older subscribers know that I am a fervent advocate of compounding. This is the reason that I never buy stocks that don't pay dividends. The dividend-less stock offers only one purpose. That purpose is to rise. Why buy a one-purpose stock when you can have a two-purpose stock. The two-purpose stock is the stock that has a long record of paying dividends. The exception is gold stocks which represent insurance against a deteriorating paper dollar.

NOTES & QUOTES – I visited the Ikea furniture store here in San Diego for the first time last week. The place was huge – and crowded. In fact, it was a madhouse. The store was on two floors, each floor the size of a city block. Huge. Merchandise in every direction – furniture, glassware, lamps, rugs, candles, you name it, it seemed to be there.

The founder, Ingvar Kamprad is 76 years old and very careful with his $13 billion (*Forbes* magazine lists him as the 17th wealthiest man in the world). He drives a ten-year old Volvo, buys his fruit and vegetables in the afternoon when prices are lower. He lives in Switzerland and is so thrifty that he washes his plastic cups to recycle them. Kamprad started Ikea in 1943. It is now international; there are 154 giant stores spanning 22 countries with 70,000 employees, but including franchises there are 175 stores in 31 countries.

The "secret of Ikea is extremely simple – make very affordable furniture, well designed (it's all modern) and aim for the

masses. Ikea is now the worlds biggest catalogue mailer, sending out over a million fat catalogues each year. As for Ikea's inventory system, I wasn't impressed. I ordered a table, waited an hour for it, and was finally told they were out of it. I ended up buying a table at Staples, which was delivered to my home two days later.

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Water – I've written about water before, and I receive a lot of questions about water. The world's climate is running to extremes with some parts of the world flooded and other parts increasingly parched. One inescapable fact about the world's water supply is that it is limited. Less than 1% of the world's water is fresh water that can be used for drinking or agriculture, and the demand for that water is rising rapidly.

A little more than half the world's available fresh water is being used each year. That proportion could climb to 75% within 25 years. And if the rest of the world's people used as much water as Americans, it could climb to 90%. Water tables are falling on every continent. My own guess living here in parched Southern California is that shortly the US and many other nations will have to turn to desalinization plants.

What about investing in water companies? Sounds like a great, logical idea. The only trouble is in surveying dozens of water companies, I see where very few of their stocks seem to be going anywhere. Why is this? I think as the water situation becomes even more critical, water companies will be under increasing regulation. Furthermore, if the need for water becomes critical it would not surprise me if many water companies were taken over by their respective governments. There is also the problem that impedes water stocks which is that water can easily be contaminated or poisoned. Anyway, and for whatever reason, the water stocks, despite all that we know about the coming water emergency, are not acting well. I wouldn't buy any of them at this point.

LATE NOTES — I have never done this before, but I want those subscribers who don't, for whatever reason, read my daily web remarks to understand what I see coming up. The following is from my site posted on September 5. Regular subscribers might do well to read this again.

Here on the economic front Americans are loading up on "nothing down" cars and "very little-down" houses. Debts are piling on top of debts, and it's almost as if consumers have drifted off into never-never land. The Greenspan Fed may think they're pulling a "fast one" by keeping consumers ever buying with the help of record low interest rates. In my opinion, by loading consumers up with debt they're putting consumers and the US economy in a frightful and fragile position, the worst possible condition to withstand the coming onslaughts of the bear.

Greenspan and the Feds don't understand how bear markets work. They don't understand that they are powerless to reverse the primary trend of the market. They don't understand that the bear market will continue relentlessly, and that the worse the debt situation of the nation, the greater the destruction potential for the bear.

What the Fed with its low-low interest policy is doing is taking away potential sales from next year and the year after and the year after that. "Never put off to tomorrow what you can do today," runs the old adage, and believe me, when it comes to buying on credit that's exactly what's happening on the part of America's consumers, it's happening — in spades!

As for the stock market, we've just had the first 90% downside day. What this 90% day signifies is that the stock market is now open to, or amenable to, panic. I think where we are now is on track for a wide-open panic phase of this bear market. Note, I did not say a panic moment or a panic day — I said a panic **phase.** The panic phase could take a week or a few weeks or a few months.

Before the panic has ended, stocks will be knocked to their knees, consumers will be in shock, the housing bubble will have burst as will the auto-buying bubble, the July 23 lows will be history, and the "A" wave of the bear market will finally have come to an end.

When the panic phase ends, investors and speculators will be in shock and the stock market will appear to be shattered -- torn apart, literally in pieces. That will give us the most "sold-out" market in years if not decades. This sold out market will provide the base for the corrective (upside) wave "B" of this bear market. The "B" should be an upside whopper, and it should carry well into next year. After this corrective "B" leg will come the final "C" leg — but I'll talk about that when the time comes.

Question — "Russell, why do you think the coming panic will be so severe?"

Answer — Ironically, the reason I believe it will be so severe is that it has been preceded by the largest load of false bullishness, across-the-board denial, trash talk, Wall Street baloney, that I have ever seen. It has been preceded by weeks and months of misguided optimism and ignorance concerning the meaning of the primary bear trend.

Instead of understanding that this is a bear market and therefore preparing for trouble, the government has been spending its head off, states and cities have been running up deficits, business has loaded up on debt, and consumers have been buying as if a bull market is just starting. All of this lays the groundwork for shock, surprise and horrendous losses. Frankly, I can't remember a situation like this in the half-century that I've been watching markets.

INVESTMENT POSITION – It remains, alas, a primary bear market, which is why I've kept Mr. Bear in the box. At this point in the bear market, if you haven't already bought top-quality bonds, I guess the best thing to do is move into T-bills and just sit tight. The reason I say that is because I believe between now and the end of the year (possibly during the first quarter of next year) we're going to see a string of panicky 90% downside days, and this string will hopefully end the first major down-wave of this bear market.

Therefore, the best advice I can give you is to stay out of stocks, get into T-bills or a money market fund, and sit on the sidelines. Sure, I know, there's no return from T-bills, but you won't take a loss either and you'll be able to sleep well at night.

As this first wave down, which I call the "A" wave, runs to completion, I think we're going to be seeing plenty of wild and volatile action – stay safe, stay in T-bills and stay on the sidelines. Oh yes, one more thing – use any market strength ahead to unload whatever common stocks you may still own (except for gold shares). Any rallying action here is a perfect chance to get into a safe position with T-bills.

The following ten-dollar and below gold shares can be bought and held almost as if they represent perpetual warrants on gold. They are GLG, GG, BGO, KGC, ECO, BGO, DROOY and GSS. An assorted package of these gold shares can be bought and just put away. This is a gold bull market. In due time (and it may take some patience) I believe a package of these gold shares will work out well. Buy 'em now while there is still major skepticism toward gold.

Next Mailing: October 2, 2002